DEPARTMENT OF STATE REVENUE

02-20050301.LOF

Letter of Findings Number: 05-0301
Adjusted Gross Income Tax
For the Years 1998-2000

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax.–Consolidated filing methodology

Authority: Ind. Code § 6-8.1-3-3; 45 IAC 15-3-2; *Wabash, Inc. v. Dep't of State Revenue*, 729 N.E.2d 620 (Ind. Tax Ct. 2000); Information Bulletin # 23 (suspended 1995).

Taxpayer protests the assessment of adjusted gross income tax based on use of a different methodology for computing tax for a consolidated group.

II. Penalty- Request for waiver

Authority: Ind. Code § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the Department's imposition of the ten percent negligence penalty, requesting a waiver for reasonable cause.

STATEMENT OF FACTS

Taxpayer consists of a group of corporations engaged in retail merchandise sales. Taxpayer's parent first registered to do business in Indiana several years ago. Since the late 1980's, Taxpayer has filed consolidated corporate income tax returns. Taxpayer used a "stacked" method of computing its adjusted gross income (i.e., each entity determines its apportionment factors separately, applies the apportionment factor to that entity's adjusted gross income, then adds the various adjusted gross income amounts for the entities together) from its first consolidated return including the returns for the tax period at issue in this protest. However, as a result of Department audit, the Department determined that Taxpayer should have used the traditional method of apportionment (i.e., the Indiana property for all entities in the group are added together, divided by the property for all entities in all jurisdictions, repeated for payroll and sales, then the apportionment factor is determined per statute, and finally the apportionment factor is multiplied by the combined income of the entities in the group). The Department assessed additional tax and penalties, which Taxpayer protested.

I. Adjusted Gross Income Tax.–Consolidated filing methodology

DISCUSSION

Taxpayer protests that the assessment was improper based on prior Department treatment of consolidated returns, including those of Taxpayer. Taxpayer states that the Department historically preferred the "stacked" method of computing adjusted gross income for corporations in a consolidated group. In particular, Taxpayer notes that it was assessed for a period in the early 1990's based on the same rationale that the Department asserted in the current protest, and that Taxpayer's protest on the issue of Taxpayer's consolidated filing methodology was sustained in a letter of findings issued during the late 1990's (though Taxpayer neither provided a copy of the letter of findings nor a number of the letter of findings). Taxpayer continued with the stacked method in the mid 1990's, and a Department audit concluded in 2001 allowed Taxpayer to use the stacked method. Taxpayer notes that the Department issued an information bulletin, Information Bulletin # 23, which indicated that the stacked method was the method of filing consolidated corporate income tax returns; however, that information bulletin was suspended in 1995.

In 2000 the Indiana Tax Court issued an opinion in *Wabash, Inc. v. Dep't of State Revenue*, 729 N.E.2d 620 (Ind. Tax Ct. 2000) regarding consolidated filings. In that opinion, the Tax Court indicated that the "traditional" method of filing consolidated income tax returns was the preferred method.

The simplest way of describing the differences between the methods is a hypothetical. Assume Company A has an overall adjusted gross income of $1,000,000. Company A has Indiana payroll of $10,000,000, Indiana property of $100,000,000, and Indiana sales of $150,000,000. Overall, Company A has payroll of $100,000,000, property of $500,000,000 and sales of $1,000,000,000.

Company B has an overall adjusted gross income of $1,000,000. Company A has Indiana payroll of $10,000,000, Indiana property of $100,000,000, and Indiana sales of $100,000,000. Overall, Company B has payroll of $200,000,000, property of $1,500,000,000 and sales of $2,500,000,000.

Under the stacked method of computing adjusted gross income subject to apportionment, Company A would determine its income as follows:

Payroll factor=$10,000,000/$100,000,000=0.10
Property factor=$100,000,000/$500,000,000=0.20
Sales factor=$150,000,000/$1,000,000,000=0.15
Apportionment factor=(0.10+0.20+2*0.15)/4=0.15

Indiana adjusted gross income=$1,000,000*0.15=$150,000

Company B would determine its income as follows:

Payroll factor=$10,000,000/$200,000,000=0.05

Property factor=$100,000,000/$1,500,000,000=0.0667

Sales factor=$100,000,000/$2,500,000,000=0.04

Apportionment factor=(0.05+0.0667+2*0.04)/4=0.0492

Indiana adjusted gross income=$1,000,000*0.0492=$49,200

Company A and Company B then combine their respective incomes together to arrive at a combined income of $199,200.

Under the traditional method, the two companies combine their property, payroll, and sales together to arrive at a composite number. Under the hypothetical above, the combined income is computed as follows:

Payroll factor=$20,000,000/$300,000,000=0.0667

Property factor=$200,000,000/$2,000,000,000=0.10

Sales factor=$250,000,000/$3,500,000,000=0.0714

Apportionment factor=(0.0667+0.10+2*0.0714)/4=7.24

Indiana adjusted gross income=$2,000,000*0.0724=$144,800

Under Indiana statutes and case law, the traditional method is the favored method for computing the tax liability of a consolidated group. While rare instances of deviating from the method may occur, Taxpayer has not provided sufficient information to permit deviation from the traditional method of filing consolidated corporate income tax returns.

Taxpayer further argues that the Department may not change its interpretation of a listed tax that results in an increase of a taxpayer's liability, absent a promulgation of a regulation. Taxpayer cites to Ind. Code § 6-8.1-3-3 for this proposition.

Taxpayer also cites to 45 IAC 15-3-2, which states in relevant part:

(b) An interpretation of the statutory provisions governing the listed taxes, made by a court of competent jurisdiction, which conflicts with rules promulgated by the department, will render that rule, or portion of a rule, null and void, and will become the official interpretation of the department, effective upon the date of issuance of the court's decision. If such decision is appealed by the department, the interpretation will become effective when such decision becomes final.

(c) As a general rule, the modification of a rule will not be applied retroactively. If a rule is later found to be inconsistent with changes in the law by statute or by decisions of a court of precedence, the rule will not protect a taxpayer in the same or subsequent years once the rule has been determined to be inconsistent with the law.

(d)(1) The department provides advice to taxpayers in many different forms. Rulings are issued to individual taxpayers based upon specific factual situations. Applications for rulings should be directed to the administrator of the particular division of tax from which the taxpayer is requesting a ruling. All relevant facts must be submitted in writing for such a determination to be made. The department will not issue a ruling based upon either an oral request or a written request from an anonymous taxpayer.

(2) As a general rule, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling was originally issued or to a taxpayer whose tax liability was directly involved in such a ruling. Under circumstances where a ruling to a taxpayer is revoked with retroactive effect, the notice to such taxpayer will set forth the grounds upon which the revocation is being made and the extreme circumstance under which revocation is being applied retroactively. This retroactive revocation is decided upon a case-by-case basis taking into account all relevant facts and circumstances. The department may exercise its discretion to retroactively rescind or modify rulings in the following extreme circumstances, which are not all inclusive:

(A) There was a misstatement or omission of material facts.

(B) The facts, as developed after the ruling, were materially different from the facts on which the department based its ruling.

(C) There was a change in the applicable statute, case law or regulation.

(D) The taxpayer directly involved in the ruling did not act in good faith.

Taxpayers are cautioned that changes in the law and final decisions of Appellate Court, Supreme Court and Indiana Tax Court cases are notification to the taxpayer of a possible revocation of a ruling, effective from the date of the court decision or change in the law within the statutory open period.

First, according to the Tax Court's opinion in *Wabash,* the standard method of computing a consolidated group's Indiana income was the Department's position throughout the period in question. *Wabash*, 729 N.E.2d at 625-626. Based on the court's holding, the Department did not change its position regarding filing and tax computation methods for consolidated income taxpayers.

Second, assuming *arguendo* that the Department's stance in this case represents a change from its previous position on consolidated group tax computation, a retroactive change is justified for 1998 and 1999. For 2000, the *Wabash* ruling was issued on June 1, 2000; Taxpayer did not file its Indiana returns for the year ending January

31, 2000, until November 13, 2000. Because of Taxpayer's filing its Indiana return after the *Wabash* ruling, the effect of the ruling was not retroactive for 2000.

While a retroactive change in Department policy or prior ruling–such as Taxpayer's prior letter of findings sustaining their use of a stacked method–is generally not favored, an instance where a court rules against Department policy is one of the extreme instances where the Department may change its policy or prior ruling retroactively. With respect to consolidated filing methodology, the Department stated that the stacked method of consolidated filing was the preferred method, and the Tax Court determined that the stacked-method policy did not conform to Indiana law in the *Wabash* decision. Until it is overruled by another judicial ruling or altered by statute, the Tax Court's interpretation in *Wabash* regarding consolidated filing for the periods at issue–that the standard method is the preferred method of filing consolidated returns–remains the Department's interpretation. Further, Taxpayer has not shown any extraordinary circumstances that permitted deviation from the standard method of consolidated tax return filing and tax computation.

FINDING

Taxpayer's protest is denied.

II. Tax Administration--Penalty

DISCUSSION

Taxpayer argues that it is not subject to negligence penalties with respect to the additional taxes assessed against it. In particular, Taxpayer argues that the additional tax was due to its different, but reasonable, interpretation of the statute. Accordingly, it argues that it was not negligent in its tax returns for the years in question.

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. Ind. Code § 6-8.1-10-2.1. The Indiana Administrative Code further provides:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.
>
> (c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
>
> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
>
> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.
>
> 45 IAC 15-11-2.

Taxpayer has provided sufficient information to conclude that it acted with ordinary business care when it filed its returns for the years at issue. While the Department disagrees with Taxpayer's method of computing its tax, Taxpayer has established that it was not negligent with respect to the issues in its assessment.

FINDING

Taxpayer's protest is sustained.

Posted: 08/02/2006 by Legislative Services Agency
An html version of this document.